Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

JUN 1996

In the Matter of	)	
	)	
Allocation of Costs Associated With	)	CC Docket No. 96-112
Local Exchange Carrier Provision	)	
of Video Programming Services	)	

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<u>REPLY COMMENTS OF U S WEST, INC.</u>

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SUMMARY

The Federal Communications Commission ("Commission") should adopt a flexible, streamlined approach to the allocation of costs between regulated and nonregulated services, consistent with its approach to Open Video Systems generally. U S WEST, Inc.'s proposed 50/50 subscriber-based approach to cost allocation has substantial merit and furthers the Commission's goals better than any other approach. Other commenters' proposals reflect their own self-interest and do not strike the appropriate balance needed to facilitate the development of competition in the cable and telephony industries.

Spare capacity and reallocation of costs do not require any special changes or adjustments in the rules. The outcome of this proceeding will strongly influence local exchange carrier ("LEC") incentives to invest in the development and construction of integrated broadband networks. Rules that result in overallocation of costs to nonregulated services would chill the introduction of those new services by LECs, and would not serve the public interest.

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REPLY COMMENTS OF U S WEST, INC.

U S WEST, Inc. ("U S WEST") respectfully submits these reply comments in response to the initial submissions addressing the Federal Communications Commission's ("Commission") Notice of Proposed Rulemaking in the above-captioned docket.[1]

I. INTRODUCTION

The Commission is on the right track with implementation of Open Video Systems (or "OVS"), as demonstrated by its recent OVS Order.[2] As Commissioner Ness acknowledged, however, cost allocation is the "final piece" of OVS

[1] In the Matter of Allocation of Costs Associated with Local Exchange Carrier Provision of Video Programming Services, CC Docket No. 96-112, Notice of Proposed Rulemaking, FCC 96-214, rel. May 10, 1996 ("Notice").

[2] In the Matter of Implementation of Section 302 of the Telecommunications Act of 1996; Open Video Systems, CS Docket No. 96-46, Second Report and Order, FCC 96-249, rel. June 3, 1996 ("OVS Order").

implementation.[3] It is also the most critical piece because, as long as prices for either local exchange service or video service are tied to costs, no other aspect of the OVS framework would have a greater impact on the incentives of local exchange carriers ("LEC") to build integrated broadband networks. The same "flexible and deregulatory approach"[4] that the Commission adopted in the OVS Order is needed here. U S WEST strongly encourages the Commission not to change course at this pivotal stage. To borrow Commissioner Chong's analogy to "the Road,"[5] OVS is running strong but the race is not yet won. The last mile is cost allocation.

The positions espoused in this proceeding were fairly predictable. The interexchange carriers' comments reflect their desire to enter the local exchange business at the lowest possible cost to themselves without constructing their own facilities. The LECs' comments reflect their desire to enter new nonregulated businesses efficiently with minimal impact on their regulated businesses. And the cable companies' comments reflect their desire to prevent telephone companies from competing with them in the provision of video services. Because of the fact that U S WEST's business interests cut across these traditional lines, U S WEST was forced to view the cost allocation question from a broader perspective. As a result, U S WEST worked to come up with an approach that satisfies both sides of its

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[3] See Separate Statement of Commissioner Susan Ness, dated May 31, 1996, re: Open Video Systems.

[4] See Separate Statement of Commissioner Rachelle B. Chong, dated June 2, 1996 at 7.

[5] Id. at 3, 6 and 7 (referring to "the long and winding road to allowing local exchange carriers . . .to play a broader role in the video market.").

business (telco and cable). U S WEST's approach also satisfies the Commission's goals (e.g., relatively easy to administer, adaptable to changing technologies, cost-causative).

II. U S WEST'S PROPOSED 50/50 SUBSCRIBER-BASED METHODOLOGY IS THE BEST APPROACH

Of the many parties that filed comments in this proceeding,[6] U S WEST is unique. While other parties claim that their proposals are "fair"[7] and "objective,"[8] no other commenter represents both the incumbent LEC and the incumbent cable perspective.[9] What became clear during U S WEST's internal discussions on cost allocation is that reasonable people with differing interests can develop and agree

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[6] Commenters referenced herein include: Alabama Public Service Commission ("Alabama PSC"); AT&T Corp. ("AT&T"); Bell Atlantic Telephone Companies ("Bell Atlantic"); BellSouth Corporation and BellSouth Telecommunications, Inc. ("BellSouth"); BroadBand Technologies, Inc. ("BroadBand"); California Cable Television Association ("CCTA"); Comcast Cable Communications, Inc. and Adelphia Communications Corporation ("Comcast"); Cox Communications, Inc. ("Cox"); Florida Public Service Commission ("Florida PSC"); MCI Telecommunications Corporation ("MCI"); National Cable Television Association, Inc. ("NCTA"); The NYNEX Telephone Companies ("NYNEX"); Scripps Howard Cable Company ("Scripps Howard"); Southern New England Telephone Company ("SNET"); Southwestern Bell Telephone Company ("Southwestern Bell"); United States Telephone Association ("USTA"); and U S WEST.

[7] See Cox at 8 (allocation of 75 percent of common costs to nonregulated services is "the fairest and simplest approach"); Scripps Howard at 3 (fixed factor only way to ensure that costs are "fairly apportioned"); AT&T at 4 (fixed factor based on Total Service Long Run Incremental Cost ("TSLRIC") studies will establish "an appropriate and fair" allocation).

[8] See Florida PSC at 2.

[9] See U S WEST at 1 (referring to U S WEST's significant in-region telephony and out-of-region cable interests).

on a balanced approach when terms are clearly defined, and when the desire to throw obstacles in the other side's path is removed from the process.

As a result, U S WEST's proposed methodology comes closest to achieving the Commission's goals in this proceeding.[10] In its initial comments, U S WEST refined the Commission's 50/50 fixed factor approach to allocating common costs between regulated and nonregulated services by introducing a per-subscriber element. U S WEST also demonstrated that few changes are needed to the existing Part 64 rules and procedures to implement this methodology. Most of the other proposals are either too complex, too simplistic, or too extreme. Only a balanced approach will enable competition to flourish in both the cable and telephone industries.

A. AT&T's TSLRIC-Based Methodology And MCI's Proposed Approach Are Unworkable

AT&T proposes that the Commission prescribe a fixed factor for allocating the shared costs of loop plant between regulated and nonregulated activities, and argues that the fixed factor should be based on TSLRIC studies.[11] AT&T further argues that the TSLRIC studies should be performed pursuant to the so-called Hatfield Model.[12]

[10] Notice ¶ 22 (citing three basic goals, i.e., "facilitate the development of competitive telecommunications service offerings . . . give effect to provisions relating to local exchange carrier entry into video distribution and programming services markets . . . ensure that ratepayers pay telephone rates that are just and reasonable.").

[11] AT&T at 4.

[12] Id. at 5 n.8.

There are several problems with AT&T's proposed methodology. First, a TSLRIC approach cannot be used in assigning total loop costs because TSLRIC (at least as AT&T defines it) does not include total costs. By not reflecting either the up-front cost of providing a network with sufficient long-term capacity, or the cost of supplementing the network at a later date, the Hatfield Model understates the TSLRIC of basic local telephone service.[13] Also, TSLRIC is a methodology for determining the incremental price of discrete products and services, not for allocating embedded costs.

Second, the methodology is confusing and would not be simple to administer because the numbers used to develop the ratios would be difficult to audit and verify. Third, the methodology is overly burdensome to the incumbent LECs. TSLRIC cost studies are very time-consuming to perform on this scale. In addition, the Hatfield Model is a highly-controversial application of TSLRIC, and anything premised on the Hatfield Model is inherently suspect. AT&T has introduced different versions of the model in different proceedings,[14] and has refused to let anyone see either the model itself or the inputs to that model.[15]

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[13] See, e.g., U S WEST's Reply Comments, CC Docket No. 96-98, filed May 30, 1996 at 20-21 ("U S WEST's May 30, Reply Comments"); U S WEST's Reply Comments, CC Docket No. 96-45, filed May 7, 1996 at 11-14.

[14] Sometimes the Hatfield Model includes local network cost elements, sometimes it does not. For example, in universal service workshops in California, Hatfield supplemented the local network cost elements in its original model but did not include these additional network cost elements in a later proceeding in Utah. The Hatfield Model estimated the statewide average loop investment for the U S WEST study area in Utah at $361. If the average investment level were that low, alternative network providers would have built networks in that area long ago.

Finally, AT&T's proposed approach is not likely to yield useful results because it is premised on a faulty assumption. AT&T, by way of example, appears to represent that it would cost more to build an integrated loop plant than to build a stand-alone video loop plant and a stand-alone telephony loop plant.[16] If that were the case, there would be no incentive to build an integrated network, and the whole question of cost allocation would be moot. AT&T also appears to assume that it would cost more to build a stand-alone video plant than stand-alone telephony. Actually, it usually costs less. AT&T appears to have come up with an approach that would drive telephone prices below their true economic costs by removing arbitrarily a significant amount of costs from the regulated rate base.[17]

Similarly, MCI's approach appears to be motivated by its desire to enter into the local exchange business at a very low cost to itself by mis-assigning costs. MCI agrees with the Commission's proposal to cap costs allocated to regulated services at the stand-alone cost of providing a telephone network, and then advocates that the Commission adopt the estimates of stand-alone costs in the Hatfield Model to compute the allocator.[18] Again, any form of regulation based on the Hatfield Model

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AT&T produced a new version of the Hatfield model in CC Docket No. 96-98 which cannot be reconciled with earlier versions.

[15] U S WEST is filing a Petition in CC Docket No. 96-98 to compel AT&T and MCI to permit discovery of various the Hatfield Models and their inputs.

[16] See AT&T's example where it applies the methodology using the following numbers: video loop plant equals \$3 billion, telephony loop plant equals \$2 billion, dual-purpose loop plant is \$6 billion. AT&T at 5-6 n.9.

[17] See generally U S WEST's May 30, Reply Comments.

[18] MCI at 6-7.

would be inherently arbitrary and irrational. MCI's assertion that "some of [the Tier One incumbent LECs'] embedded customer operations expense is wasteful"[19] is totally unsupported, and MCI's conclusion that its 62 percent allocator is a "conservative estimate" of embedded costs[20] is sheer speculation.

B. Some Form Of Cost Allocation Is Needed In The Short-Term

Some LECs contend that there is no need for cost allocation rules when the LEC is under price cap regulation, and argue that the Commission should eliminate the Part 64 cost allocation rules.[21] This approach is too simplistic for several reasons. First, interconnection under Section 252(d)(1)(A) of the 1996 Act[22] is to be "cost-based" no matter what the price cap rules say as to the pricing of tariffed services. Second, "sharing" under the existing price cap rules retains rate of return elements. Third, even under "pure" price cap regulation where the carrier is not subject to sharing, the price cap agreement sometimes contains sunset provisions that would enable the carrier to elect sharing at a later date. U S WEST recognizes that some form of cost allocation is necessary to protect regulated ratepayers from cross-subsidization until the transition to competition is complete.[23]

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[19] Id. at 7 n.13.

[20] Id.

[21] See, e.g., Southwestern Bell at 4 ("the Commission should forebear from applying Part 64 to price cap LECs"); BellSouth at 9 ("[t]he Commission can start by eliminating the Part 64 cost allocation rules.")

[22] Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56, 67 (1996) ("1996 Act").

[23] Other LECs recognize this as well. See, e.g., Bell Atlantic at 8.

C. A Fixed Allocator Applied Uniformly To All LECs Achieves Administrative Simplicity At The Expense Of Accuracy, Fairness And Adaptability

Several commenters, including some of the LECs, support the Commission's proposal to apply a fixed factor to allocate costs between regulated and nonregulated services.[24] U S WEST continues to oppose the fixed-factor approach because it does not even attempt to reflect actual usage of the nonregulated facilities.[25] Moreover, the very idea of a uniform, prescriptive approach is completely at odds with the diverse, expansive vision of the 1996 Act.[26]

All but one of the cable companies participating in this proceeding seek an allocation of at least 70 percent of common costs to nonregulated services.[27] This position likely would result in an overallocation of costs to nonregulated services.

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[24] See, e.g., id. at 9-10 (Commission should allow companies the option of using a fixed allocation factor selected from an established range; history suggests a range of 25-30 percent); SNET at 16-17 (50/50 fixed factor to allocate broadband loop common costs).

[25] SNET deserves credit for owning up to the fact that its proposed 50/50 fixed allocator is "premised on the optimistic assumption that [SNET's cable affiliate] and SNET [the telco] each may ultimately have an equal number of subscribers . . . ." Id. at 17.

[26] U S WEST agrees with Southwestern Bell's discussion as to why a fixed factor would be completely arbitrary and incompatible with the Joint Cost Order. Southwestern Bell at 13-16.

[27] See, e.g., Cox at 8 (supports allocation of 75 percent of common costs to nonregulated services); CCTA at 19-20 (at least 76 percent of common costs should be allocated to nonregulated services); Comcast at i, 4 (70 percent allocation to non regulated services is "the minimum necessary"); NCTA at 21 (Commission should allocate 75 percent of common costs to nonregulated services). The one notable exception is Scripps Howard, which supports a fixed cost allocator but does not state at what level the allocator should be fixed. See Scripps Howard at 3-5.

The cable companies repeatedly emphasize protection of ratepayers and administrative simplicity,[28] and barely acknowledge other important goals such as encouraging the development of broadband technologies that will bring competition to the cable services market.[29] These companies know that overallocation of common costs to nonregulated service could dissuade the LECs from deploying broadband services altogether. Of course they favor an approach that would produce such an overallocation. The self-interest of these parties blurs their objectivity and casts a cloud over their credibility in this proceeding. Simply stated, such an allocation would discourage video investment by telcos and would serve to drive telephone rates up, not down.

III. ALLOCATION OF SPARE CAPACITY SHOULD FOLLOW ALLOCATION OF THE UNDERLYING INVESTMENT

A number of parties have suggested various ways in which "spare capacity" should be allocated. Some of these are very complex[30] and some as simple as allocating virtually all spare to video.[31] However, as noted by NYNEX, spare capacity is an "engineering concept" not a cost that is entered on the books, i.e., there is no accounting classification in Part 32 for spare capacity.[32] Nor would it be

[28] E.g., NCTA at 12; Cox at 9; Comcast at i, 2, 3.

[29] See NCTA, Attachment 1, Affidavit of Leland L. Johnson at 1 n.3.

[30] Alabama PSC at 7.

[31] CCTA at 21-22.

[32] NYNEX at 18.

feasible to establish one because the concept of spare capacity varies depending on the architecture and the current state of technological advancement. In some architectures, telephony and video occupy separate cables each with its own spare capacity and 100% assigned to its respective usage. In other architectures, telephony and video occupy separate fiber within a sheath. There may be spare capacity within each fiber as well as spare fibers within the cable.

Consequently, the only practical way to address spare capacity is to acknowledge that it will flow with the allocation of the investment.[33] Thus, if 25% of the fiber cable is allocated to video it will include 25% of the spare capacity however it is defined. The more the cable is used for video the greater the assignment of the investment and therefore the greater the assignment of the spare. Further refinements to this methodology would not produce meaningful results.

IV. EXOGENOUS TREATMENT OF COST REALLOCATIONS TO NONREGULATED SERVICES IS NOT IN THE PUBLIC INTEREST

A. Exogenous Treatment Of Cost Reallocations To Nonregulated Services Would Be Inconsistent With The 1995 Price Cap Order

U S WEST agrees with USTA that cost allocations resulting from the LECs' offering of video services should not result in exogenous treatment under the

[33] In this regard, U S WEST agrees with USTA's assertion that "[r]equiring additional cost pools and special allocation rules only for 'spares' is administratively burdensome and not necessary to ensure that 'spares' are appropriately allocated between regulated and nonregulated services." USTA at 21.

Commission's price cap regulatory regime.[34] The definition of exogenous costs[35] does not require treatment of cost changes occasioned by Part 64 accounting changes as exogenous, as some have argued.[36] The Commission has clearly modified the rules dealing with exogenous cost treatment, limiting that treatment to changes which actually "affect[ ] cash flow."[37] The transfer of costs from regulated to nonregulated accounts does not meet this standard, and hence is not covered by the existing exogenous rules. In other words, the <u>1995 Price Cap Performance Review Order</u>[38] modified the rules on exogenous cost treatment, and the superseded rules cannot be used as precedent for treating accounting changes like those contemplated herein as exogenous.

B. Exogenous Treatment Of Cost Reallocations To Nonregulated <u>Services Would Stifle LEC Video Investment</u>

In previous proceedings, the Commission has stressed the importance of achieving productivity by developing new services:

> Prices are held to a maximum level by the cap, much as they are by the rivalry among companies in competitive markets. The carrier gains the opportunity to earn higher profits, but may do so only by

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[34] <u>Id.</u> at 12-14. <u>See also</u> Broadband at 9-10 (Commission should not treat any reallocation of costs as exogenous because purpose of price cap rules is to create incentives for LECs to innovate and improve their productivity).

[35] 47 CFR § 61.44(c).

[36] Comcast at 8-9; NCTA at 24; Cox at 10-11.

[37] <u>In the Matter of Price Cap Performance Review for Local Exchange Carriers</u>, <u>First Report and Order</u>, 10 FCC Rcd. 8961, 9090 ¶ 294 (1995), <u>aff'd sub nom.</u> <u>Bell Atlantic Telephone Companies, et al. v. FCC</u>, 79 F.3d 1195 (DC Cir. 1996).

[38] <u>Id.</u>

> operating more efficiently or by developing new services customers want, not by raising overall prices. This opportunity to increase its profits in turn encourages the carrier to apply its resources in the most efficient manner possible, providing more and better service at lower cost. In this way, the carrier can increase its productivity, and thus its profitability.[39]

The productivity offset in the Commission's price cap regulatory regime is an incentive for the LECs to maximize the utility of their existing network through the creation and offering of new services.

In its Second Report and Order, the Commission recognized the essential linkage between productivity and utilizing the existing network through increased usage.

> An increase in average usage per common line could represent an increase in productivity, and we continue to believe that the LECs have opportunities to affect this particular form of productivity gain . . . . Improvements in network facilities and operations that improve set up times, call completion ratios, and transmission quality should also encourage usage over common lines instead of private lines and bypass facilities. Expanding features available with toll services, such as call waiting and call forwarding, and developing entirely new common line-based services such as [Integrated Services Digital Network] ISDN, would increase the value of common lines to customers.[40]

The Commission has recognized the importance of utilizing the network to develop new services as an important component of LEC historical productivity gains.

Commenters who claim that an exogenous adjustment is needed because the new service is nonregulated apparently do not understand the purpose of the

[39] In the Matter of Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, 9 FCC Rcd. 1687, 1688 ¶ 12 (1994).

[40] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd. 6786, 6794 ¶ 65 (1990).

various price cap mechanisms. When new regulated services are introduced they allow the LECs to maintain profitability by generating new revenue streams despite lower prices on existing services as a result of a declining price cap.

The productivity factor works to force prices down and acts as an incentive to increase efficiencies and develop new products and services. When costs associated with nonregulated revenue streams are allocated, the remaining costs are properly matched against regulated revenues. Thus, no exogenous adjustment is necessary because the LEC has realized no economic benefit. To require another price reduction on top of cost allocation would penalize carriers and would eliminate any incentive to develop new nonregulated services that utilize common regulated investment.

V. CONCLUSION

For the reasons discussed in its initial comments and in these reply comments, U S WEST respectfully urges the Commission to adopt rules that will permit LECs to allocate costs between regulated and nonregulated services using a 50/50 subscriber-based methodology. This approach has substantial merit, particularly when compared to the alternatives advanced by the cable companies, AT&T and MCI, and even other LECs. Since many telephone ratepayers are also consumers of video programming services, the Commission should strive for a balanced approach that encourages competition to flourish in both the telephone and cable industries.

Respectfully submitted,

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June 12, 1996

CERTIFICATE OF SERVICE

I, Kelseau Powe, Jr., do hereby certify that on this 12th day of June, 1996, I have caused a copy of the foregoing **REPLY COMMENTS OF U S WEST, INC.** to be served via first-class United States Mail, postage prepaid, upon the persons listed on the attached service list.

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